COMPARATIVE ADVANTAGE, ACTIVITY

The reading for this lesson explains why countries trade with each other. Even when countries can produce what they want on their own, they often choose to specialize. They import some things and export others. People specialize for the same reasons that countries specialize. As you read this explanation, think about the following questions:

1 Why do countries choose to specialize and trade?
2 When might they choose not to?
3 How does comparative advantage apply to you?

ABSOLUTE ADVANTAGE

Pretend for a moment that there are just two countries in the world, the United States and Canada. Pretend also that they produce only two goods, shoes and shirts. The resources of both countries can be used to produce either shoes or shirts. Both countries make both products, spending half of their working hours on each. But the United States makes more shoes than shirts, and Canada makes more shirts than shoes. This situation is shown in Table A.

TABLE A

•	Shoes	Shirts
United States	100	75
Canada	80	100
Total	180	175

Now, the sensible thing to do would be for each country to specialize. The United States should make only shoes and Canada should make only shirts. What will happen when each country spends all its working hours making one product? It will make twice as much of that product and none of the other, as shown in Table B.

TABLE B

	Shoes	Shirts
United States	200	0
Canada	0	200
Total	200	200

The world now has both more shoes and more shirts. The United States can trade 100 units of shoes for 100 units of shirts, and both countries will benefit.

In this example, the United States could make more shoes than Canada with the same resources. Economists say that it has an *absolute advantage* at shoemaking. Canada, on the other hand, had an *absolute advantage* at shirt making.

Comparative Advantage

Now suppose one country has an absolute advantage in both products. Is trade a good idea under these circumstances? Table C shows what production might be like if the United States had an absolute advantage at making both shoes and shirts.

TABLE C

	Shoes	Shirts
United States	100	80
Canada	80	75
Total	180	155

In this case, the United States can produce more of each good with the same set of resources than Canada can. The **opportunity cost** of choosing to produce more of one of the goods with the available resources will be the loss of some of the other good. The United States could produce either 200 units of shoes or 160 units of shirts. Canada could produce either 160 units of shoes or 150 units of shirts. If the United States produces only shoes, it gives up 80 units of shirts to gain 100 units of shoes. If Canada produces only shoes, it gives up 75 units of shirts to gain 80 units of shoes. The opportunity cost of producing shirts is higher for the United States, and the opportunity cost of producing shoes is lower. The opportunity cost of producing shoes is higher for Canada, the opportunity cost of producing shirts is lower. Economists would say that the United States has a *comparative advantage* in shoemaking and Canada has a *comparative advantage* in shirt making. Table D shows what happens when each country specializes in the product in which it has a comparative advantage.

TABLE D

	Shoes	Shirts
United States	200	0
Canada	0	150
Total	200	150

By specializing in this way, the United States and Canada have increased the production of shoes by twenty units over what they produced before, from 180 to 200. But the world has lost five units of shirts, going from 155 to 150. (See Table C.) Production in the United States could be adjusted to make up the difference. For example, if the United States gave up 10 units of shoes, it could produce 8 units of shirts. Table E shows the results of such a tradeoff.

TABLE E

	Shoes	Shirts
United States	190	8
Canada	0	150
Total	190	158

In this way, the total production of both goods could be increased.

Terms of Trade

What will be the **terms of trade** in this situation? Before specialization the United States produced 100 fewer units of shoes. The opportunity cost of choosing to produce 80 units of shirts was the 100 units of shoes that could have been produced with the same resources. In the like manner, Canada's opportunity cost of producing 80 units of shoes was 75 units of shirts. In the terms of trade each reduce each country's opportunity cost of acquiring the good traded for, trade will take place. In this example, Canada will not accept fewer than 80 units of shoes for 75 units of shirts and the United States will not pay more than 100 units of shoes for 80 units of shirts. Both countries must benefit for trade to occur.

The real world is much more complex than this two-country, two-product mode. Trade involves many different countries and products. And it is not always clear where a country's comparative advantage lies.